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TO: U.S.-China Security Review Commission

FROM: Gordon G. Chang

RE: China's Capital Needs

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This report estimates the capital needs of the People's Republic of China for the remainder of the current five-year plan, which covers the period 2001-05.

Contained below are estimates of the total amount of central government revenue and expenditures for each year from 2002 to 2005. Estimates are shown for major categories (defense, social security obligations, and the like).

China, of course, draws upon domestic and international capital markets for a part of its needs. As even a short visit to the People's Republic reveals, many of these needs go unmet. How does the central government determine how much it can spend to solve society's numerous problems? Beijing's leaders partially determine what they will spend by how much they think they can raise in equity markets and borrow in debt markets.

We cannot now know how these markets will behave tomorrow, but we do have information about how much debt has been issued and equity sold yesterday. Because Karl Marx was right and history does repeat itself, this report calculates how much China has raised and borrowed in the three immediately preceding calendar years (1999, 2000, and 2001). China's historical track record is the best guide we have as to what these markets can absorb in the future.

General comments on China's capital needs in the period following the current five-year plan are also included.

Many of the conclusions in this report are counter to the weight of prevailing opinion. Therefore, the report discusses other points of view. In short, the report provides to the Commissioners information upon which they can make their own assessments as to China's capital needs in the coming years.

The report, by quantifying both China's needs and the world's capacity to absorb Chinese

debt and equity in the next few years, better defines that nation's situation and makes analysis of the future somewhat more precise.

This report is divided into the following sections:

- 1) Current Central Government Finances,
- 2) Future of the Economy,
- 3) Past and Future Equity Market Activity,
- 4) Future Central Government Capital Needs, and
- 5) Funding Needs During the Eleventh Five-Year Plan.

Attached to this report are four appendixes:

- 1) Reliability of GDP Statistics,
- 2) Banking System,
- 3) Pension and Other Social Security Obligations, and
- 4) Table of Initial Public Offerings (1999-2001) and Explanatory Notes.

Summary

The central government's finances appear strong today, but current trends undermine that image. Beijing's pump-priming program, designed to attain high rates of growth of gross domestic product, is eroding the country's financial standing. As a result of this plan, sovereign indebtedness and annual budget deficits are rising and will continue to do so during the current five year plan, which ends in 2005.

Fiscal stimulus is not only expensive but also increasingly inefficient. The government's spending spree is cutting off capital where it is needed most: in the hands of private sector entrepreneurs and hundreds of millions of China's consumers. Today's growth, although impressive, is unsustainable.

Despite the government's spending program, GDP growth will trend down during the current five-year plan. The People's Republic joined the World Trade Organization just as the world economy was turning sour. China will suffer worsening trade balances as current trends continue: imports will increase substantially and export growth will decline even further. Trade deficits are likely in the near future. There must be a downturn in China soon, and 2004 will see a marked deterioration in the economy.

China has enough domestic savings for its own needs. Although most observers believe that Beijing will rely on its own capital to fund future requirements, domestic equity markets are failing. The last few years have witnessed an increasing reliance on foreign stock exchanges (and especially those of Hong Kong and New York). This trend would continue during the next few years, but political directives from Beijing are halting large foreign offerings.

Soon Beijing will have to attend to deferred needs, especially unfunded pension and other social welfare obligations and insolvent banks. To meet these and other pressing needs, the central government will have to borrow more, both from domestic and foreign sources. The country's outstanding loan obligations during the last years of the current five-year plan will increase substantially.

The result of all these trends is that China is heading to a debt crisis, which will probably occur during the first few years of the next five-year plan.